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From: Alan Sasaki *tm for*
Auditor-Controller

Subject: **Countywide Billing and Cost Recovery Task Force**

On June 5, 1995, your Board referred the Chief Administrative Officer's (CAO) study on the restructuring of the Internal Services Department (ISD), along with the Director of ISD's response to the study, to the Los Angeles County Citizens Economy and Efficiency (E&E) Commission for review and recommendations. Your Board adopted the E&E Commission report recommendation that the Auditor-Controller (A-C) oversee a study of ISD's interdepartmental billing process.

The A-C assembled a Billing and Cost Recovery Task Force consisting of representatives of the A-C, CAO, ISD, and members of the Administrative Deputies Network. The Task Force expanded the scope of the review to include Countywide billing practices and related processes.

The Task Force analyzed and developed options and recommended solutions for issues specified by the E&E Commission, as well as other issues pertinent to the study. The analysis included factors that influence billing practices and processes including subvention, grant and maintenance of effort requirements.

The federal Office of Management and Budget (OMB) regulation A87 governs the cost accounting principles and process by which government agencies recover the portion of their central support costs that indirectly benefit a federal or State program. Thus, OMB-A87 regulations were a significant influence over many of the findings and conclusions of the Task Force.

Summary of Major Findings and Recommendations

Claiming of OMB-A87 Unallowable Costs

OMB-A87 specifies the types of costs that are eligible for reimbursement under federal programs, and the cost allocation methods that must be used to allocate indirect costs to various programs. Examples of these indirect costs include the costs of the CAO, County Counsel, A-C, ISD, etc. Each year, in order to be reimbursed for these costs, all agencies must prepare a Countywide Cost Allocation Plan (CCAP) which conforms to OMB-A87 guidelines. The County's CCAP is reviewed and provisionally approved by the State Controller and subject to subsequent audit.

Throughout the year, certain County departments file claims for reimbursement from grantor agencies which include the departments' direct and indirect (department overhead) costs, intrafund transfers (IFT) of costs from other departments from which they receive service, and allocations from the County's CCAP. As part of the preparation of the CCAP, previous years' billings and allocations to departments are reviewed and adjustments made as appropriate to eliminate any charges or allocations to subvented departments that are not allowable under the cost allocation requirements as set forth in OMB-A87. The CCAP adjustment is normally processed three years after-the-fact and can result in significant budget impacts for subvented departments.

In the past, the CCAP adjustment was often positive because not all eligible costs were billed. This resulted in County claims for additional revenues. However, in the early 1990's practices such as full cost recovery, and inclusion of OMB-A87 unallowable costs in billings, resulted in the CCAP adjustment being negative. The Task Force has made recommendations to change or eliminate policies that result in the billing and claiming of unallowable costs.

BUDGETARY IMPACT

The changes recommended by the Task Force will require adjustments in the budget to reflect the impact of discontinuing billing and claiming of unallowable costs (debt service, capital expenditures, etc.). These include increasing ISD's and some other departments' Net County Cost to cover previously billed costs, with corresponding decreasing adjustments to the budgets of their client departments. In addition to adjustments necessary to correct for prior overclaiming, adjustments in the budget will also be necessary to reflect service department billings that exceed actual net

costs, and the subsequent claiming of those billings by subvented departments. For example, billings for energy services provided by the civic center cogeneration plant are not reduced for related cogeneration revenue. Also, credits due to refinancing of LACCAL debt are not netted against charges for financing billed to subvention agencies.

The adjustments necessary due to past overclaiming and overbilling will have a negative impact on the General Fund in the form of an immediate reduction in revenues, and future adjustments to a portion of subvention funding for programs such as welfare and health services. The reduction in revenues may require program curtailments wherever these revenues were used to fund current operations. These adjustments are further complicated by the maintenance of effort requirements of some programs.

For 1995-96 the CCAP adjustment is a negative \$20.2 million. This represents money we owe the State because of past overclaiming. Also, because the CCAP adjustment process is after-the-fact, and because overclaiming activity has increased over the past few years, negative adjustments may continue for at least two more years to compensate for past overclaiming.

The County has already taken steps to address the reduction in revenue by reducing the 1995-96 claims of subvented departments, and recognizing the potential impact to the 1996-97 final budget. The Task Force has recommended that the CAO oversee the adjustment of the proposed 1997-98 budget to reflect the impact of revenue reductions resulting from the elimination of unallowable costs and overbillings from subvention claims. Because the revenue generated from these overbillings has been used to finance General Fund expenditures, adjustments will need to be made for the 1997-98 budget to offset this revenue deficiency.

ACTION PLAN

The State has expressed concern over the County's billing practices and the timeliness of its cost plan. We are currently in the process of discussing these matters with the State, and hope to obtain agreement on 1996-97 interim reimbursements that will not negatively impact the County's cash flow. For 1996-97 we plan on adjusting billings for key subvented departments at the end of the year so that only allowable costs are included. In 1997-98, the budgetary changes will have permanently eliminated billing of unallowable costs.

Takeover of Services

A takeover occurs when a department decides to provide for itself a service previously provided by another department. Recently, departments have been allowed to take over a service without being required to assume responsibility for the provider's unavoidable indirect costs. The result of this practice is that overall costs to the County may increase. In addition, if indirect costs are not reduced or transferred the department losing the service must raise rates to remaining customers to compensate for the increase in per unit costs resulting from the spreading of indirect costs over remaining lines of business, or incur a budget deficit.

Takeover decisions have also been made with minimal consideration of some Countywide operational issues or possible incompatibility with a department's main mission. Matters other than cost need to be independently evaluated from a Countywide perspective including the potential loss of centralized coordination and technical expertise, the appropriateness of placing a service with a department whose main mission may not be operationally compatible with the service taken over, etc.

The Task Force concluded that takeover proposals need to be independently evaluated by the A-C and CAO to ensure Countywide cost impacts, and operational and mission issues are given proper consideration. The Task Force does not believe that the current practice provides adequate analysis of the impact such decisions have on other County departments and the operations of the County as a whole. In determining cost effectiveness, the Task Force concluded takeover decisions should be made using guidelines similar to those used for Proposition A (avoidable cost) contracting analyses to ensure that the Countywide cost effect of each takeover proposal is determined, not just the budgetary gain of the department taking over the service. Also, the Task Force concluded a transition process needs to be developed to allow the department previously providing the service to reduce overhead in a manner that does not penalize other departments receiving the provider's services, to provide the County a period to evaluate the appropriateness of further decentralization of the service, and to increase the potential for appropriate reductions in the provider department's overhead.

Budgeting Practice

Current practice involves charging departments' budgets for costs such as debt service, and rent for vacant space. These costs are allocated to departments without consideration of the level of service received, and are not subject to departmental management control, including cost cutting efforts. For example, some departments are allocated a portion of the Countywide cost of debt service. If debt service costs were discretionary, department management could take proactive steps to reduce or eliminate the costs. The practice of budgeting the costs in departments' budgets is contributing to the overclaiming problem discussed above because the costs are OMB-A87 unallowable, and some central support

budget units are required to pass them on to their client departments. Decentralized budgeting of central appropriations needs to be reviewed to ensure that it does not contribute to overclaiming of costs to federal programs.

Three problems caused unallowable costs to be claimed including: 1) The full cost recovery mandate of some central support budget units, 2) Not crediting offsetting revenues against billings to departments, and 3) Over-recovery of costs. Federal claiming requirements mandate that costs billed to federal programs reflect actual costs. Accordingly, claims must be adjusted to conform to these requirements. The Task Force has recommended changes to these budget practices to ensure they do not contribute to overclaiming of costs to federal programs.

The Task Force also made recommendations to correct problems related to billing adjustments, the review of billing rates, and billing formats. Though the Task Force attempted to balance the diverse interests of each of its members, conclusions for some issues were based on consensus rather than a unanimous decision. The Task Force appreciates the opportunity to constructively review the issues presented to them.

Billing and Cost Recovery Task Force Report
Detailed Findings and Recommendations
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Attachment - Central Support Services Decision Matrix

DETAILED FINDINGS AND RECOMMENDATIONS

Background

On June 5, 1995, the Board referred the Chief Administrative Officer's (CAO) study on the restructuring of the Internal Services Department (ISD), along with the Director of ISD's response to the study, to the Los Angeles County Citizens Economy and Efficiency (E&E) Commission for review and recommendations. The E&E Commission performed the requested review. Their report contained a recommendation that a study of the billing process, including policies and practices, be performed with the objective of significantly reducing complaints about the existing process, and developing one that can lead to better decision-making in the County.

The E&E Commission recommended a study of the billing process involving representatives of service functions and client organizations, chaired by the Auditor-Controller (A-C) acting in his fiscal oversight role for the County. The A-C assembled a Billing and Cost Recovery Task Force consisting of representatives of the A-C, CAO, ISD, and volunteers from the Administrative Deputies Network. The goal of the Task Force was to propose an improved billing and cost recovery process incorporating the best of public and private sector practices. Though the E&E Commission recommended studying the billing process and related functions of ISD, the Task Force expanded the scope of the review to include the Countywide billing process and related functions.

Since operating decisions are made based on information from the billing process, the E&E Commission believed it to be essential that the process be understandable and that the information provided motivate management to make decisions in the best interest of the County. Thus, the E&E Commission specified that the following and any other appropriate issues be considered as part of the study:

- The level of control a department has over cost incurrence
- Expenditures covering investments for the future, such as advanced technology efforts and perhaps capital expenditures, might not be billed out but rather specifically authorized by the Board each year as investments.
- Responsibility for funding cost overruns, unanticipated expenditures, cost of substandard performance, etc., should be clearly defined on a "who-is-responsible" basis.
- Requirements of grant, State, federal claiming, etc., have to be met although perhaps not by the billing process.

- There should be some incentive for the service provider to reduce costs and improve efficiency.
- The process should discourage monopolistic behavior on the part of the service provider.
- Charges for real estate, if made, should be market-based and not tied to County financing.
- Relationships between varying service levels (volume) and different cost levels should be understandable and should correlate.

Methodology

In response to the Board's motion, the A-C compiled a list of billing and cost recovery issues based on documentation from the CAO, ISD, the E&E Commission, and other pertinent documents. This "Issues List" was organized into general categories of concern including:

- Billing and Net County Cost
- Budgeting
- Service Level
- Standards and Policy
- Subvention and Countywide Cost Allocation Plan Requirements

The Issues List was distributed for comment to Administrative Deputies in all County departments along with a questionnaire soliciting information about their Department's billing and cost recovery efforts and experiences, including the extent of staff time devoted to billing and bill review activity. To better understand the extent of Countywide billing activity the A-C also developed a list of services that are billed based on 1994-95 actual expenditures.

The A-C performed a survey of public and private sector billing and cost recovery to identify the best practices in use by other government entities and private industry. Coinciding with this effort was a billing and cost recovery survey of all California counties performed by El Dorado County. The responses to these surveys were considered when addressing each applicable issue.

The Task Force analyzed and developed options and recommended solutions for each issue. The analysis of the issues included consideration of factors that influence the billing system including subvention, grant and maintenance of effort requirements established by the federal and State governments.

Though the Task Force attempted to balance the diverse interests of each of its members, conclusions for some issues were based on a consensus rather than a unanimous decision.

Compliance with Federal Cost Accounting Guidelines

Cost Reimbursement and the Countywide Cost Allocation Plan

The primary influence over billing and cost recovery issues addressed by the Task Force is federal Office of Management and Budget (OMB) regulation A87, Cost Principles for State, Local and Indian Tribal Governments. OMB-A87 governs the cost accounting principles and process by which government agencies recover the portion of their central support costs that indirectly benefit a program which is at least partially funded by federal and/or State resources. Examples of such central support costs include the costs of the CAO, County Counsel, A-C, ISD, etc., related to operation of State and/or federal programs.

OMB-A87 specifies the types of costs that are eligible for reimbursement under federal programs, and the cost allocation methods that must be used to allocate indirect costs to various programs. The County's compliance with OMB-A87 is monitored by the State Controller. The allocation of indirect costs requires the accumulation of costs into separate cost groupings which then are allocated individually to benefited functions by means of a ratio which best measures each function's relative degree of benefit. Other indirect costs are recovered through direct billing that includes the billing department's overhead.

Throughout the year County departments file claims for reimbursement which include the claiming departments' direct and indirect (department overhead) costs, intrafund transfers of costs from other departments from which they receive service (IFT), and allocations from the County's Cost Plan. Allocated costs include prior year costs from support departments and central budget units that were not billed. Each year the A-C prepares the Countywide Cost Allocation Plan (CCAP) based on a review of previous years' billings and allocations to departments and adjustments made as appropriate. These adjustments are to correct (increase or decrease) the amounts billed or allocated. This is necessary because these billings and allocations were based on estimates. Adjustments also have to be made to eliminate any charges or allocations to subvented departments that are not allowable under the cost allocation requirements as set forth in OMB-A87. These adjustments are reported

to departments so that subvention claims can be increased or decreased as necessary. Because these adjustments are after-the-fact, they often result in unanticipated budget impacts for subvented departments.

The CCAP adjustment is normally processed on federal claims three years after-the-fact. For example, in 1995-96 an adjustment will be processed for 1992-93 billing/allocation variances. This adjustment will also be used as a preliminary estimate of the variance for 1995-96 and used to adjust the 1995-96 claims.

In the past, the CCAP adjustment was often positive because not all eligible costs were billed. This resulted in County claims for additional revenues. However, in the early 1990's policies such as full cost recovery (FCR) resulted in the CCAP adjustment being negative. In addition, the practice of budgeting departments to over recover costs has further increased the negative effect of the CCAP adjustment.

The following example, utilizing the Department of Public Social Services (DPSS), illustrates the effect of over billings on the CCAP process:

The 1992-93 CCAP adjustment which will be claimed in 1995-96 is a negative \$9 million composed of a variance between actual billed and eligible costs of \$6 million and the preliminary estimate for 1992-93 (based on 1989-90 data) of a positive \$3 million. Because the 1992-93 variance will be used as the preliminary estimate of the 1995-96 CCAP adjustment, the total claim adjustment (i.e., claim cut) in 1995-96 will be a negative \$15 million (\$9 million to the 1992-93 claim and \$6 million to adjust the 1995-96 claim).

Claiming of Unallowable Costs

Many departments bill other departments for the services provided to them. The costs associated with these services include the direct labor and materials necessary to complete the service, and indirect costs. As noted, costs billed to subvented departments such as DPSS are then included as part of DPSS' claim for reimbursement.

Three practices caused unallowable costs to be claimed including:

- 1) County policy mandates that ISD recover 100% of their costs - all categories of costs they incur are billed to the users of their services, including OMB-A87 unallowable costs. Unallowable costs billed as a result of the FCR mandate include interest on debt, rent for vacated space, etc.

- 2) The County practice of not passing credits back to departments - For services such as power generation, excess energy is sold to utility companies but the resulting revenue is not credited back to customer departments. Billings to federal programs must be net of any offsetting revenues.
- 3) Over-recovery of costs - Charges from central service departments that exceed actual costs can result in overclaiming when the charges are passed along to grantor agencies.

Since DPSS and other subvented County departments include unallowable costs billed to them on their claims for reimbursement, their claims overstate the amount of claimable costs. The CCAP is the vehicle whereby unallowable billed or allocated costs are adjusted so that subvention claims are in accordance with OMB-A87 requirements.

The current year's CCAP includes an approximately \$20.2 million negative adjustment to reflect this over-claiming. Because the CCAP adjustment is after-the-fact, negative adjustments will continue for at least two more years. Negative adjustments result in an immediate reduction in revenues, and future adjustments to a portion of subvention funding for programs such as welfare and health services.

The State has verbally discussed with the A-C the possibility that it will stop full interim reimbursement unless the County's adjusts its claiming practices to comply with OMB-A87 guidelines.

Recommendation

1. Revise County practice so that departments no longer include OMB-A87 unallowable costs in their bills and claims.

ISD's Full Cost Recovery and Entrepreneurial Mandates

In a June 13, 1995, report to the Board regarding restructuring of ISD, the CAO recommended that the Board "Evaluate the advisability and feasibility of reversing the full cost recovery policy where: 1) departments have very little or no choice in using a particular service; and 2) greater control, oversight and Countywide policy direction is needed." The report further states that "ISD was given a difficult mission that lacked sufficient clarification (i.e. entrepreneurialism and full cost recovery within a local government environment)."

In its June 1995 review of this report, the E&E Commission reiterated its support of the FCR concept, stating that any deviation from FCR should be fully analyzed and justified prior to implementation. The Task Force evaluated the FCR and entrepreneurial practices including an assessment of their Countywide effect on billing and cost recovery practices.

The entrepreneurial mandate is not a mandate to produce a profit as defined by private industry. Rather, it is a customer service approach to operations that includes offering client departments a choice of service providers, operating in a business like manner, maximizing customer satisfaction, providing services within estimated amounts, etc. Based on this definition, the Task Force agreed that ISD should retain the customer service focus of its entrepreneurial mandate.

The practice of FCR was adopted for ISD and certain centralized budget units (e.g., telephone utilities, rent, etc.) when ISD was created in 1989. This has resulted in ISD passing along all of its costs to users of its services, including OMB-A87 unallowable costs, as discussed previously.

The Task Force concluded that the CAO should relieve ISD of its FCR mandate, and review the FCR mandate of other budget units (utilities, etc.) to determine if they contribute to overclaiming. The Task Force also concluded that billing rates and cost allocations to subvented departments beginning in fiscal year 1997-98 should be in accordance with OMB-A87 and State requirements. Such a change will require budget adjustments increasing ISD's and other departments' Net County Cost (NCC) to cover previously billed costs. Adjustments will have to be made in the budgets of their client departments. This will result in a significant net overall reduction in General Fund revenue in the 1997-98 fiscal year as unallowable costs will no longer be claimed.

In addition, the County's practice of budgeting costs such as debt service and rent for vacant space needs to be reviewed. In many cases these costs cannot be claimed, or can only be partially claimed. The practice of budgeting the costs in departments' budgets is contributing to the overclaiming problem as central support departments in some cases pass the unallowable portion of these costs on to their client departments. The CAO should also change its budgetary practice of mandated billing for unallowable costs. This practice also contributes to overclaiming.

Recommendations

2. The CAO relieve ISD of its FCR mandate, and review the FCR mandates of other budget units to determine if they contribute to overclaiming.
3. The CAO oversee the adjustment of the 1997-98 budget to reflect this change in policy. Adjustments will be necessary in departments' operating budgets to reflect the reduction in revenue resulting from the elimination of unallowable costs from OMB-A87 claims.
4. The CAO and A-C ensure that budgetary practices do not result in claiming of unallowable costs.
5. The A-C monitor CCAP adjustments and initiate corrective action when material adjustments occur.

Billing for Services

Continued Billing for Services

The Task Force considered the potential use of the CCAP as an alternative to billing for services. However, the benefits of billing outweighed use of the CCAP as an all-inclusive tool for billing. These benefits include using billing to ration discretionary resources, to accelerate recovery of expenditures from grantors, to add predictability to the billing process (i.e., fixed fee billing), and to demonstrate compliance with State regulations that require the County to contribute a prescribed level of funding match to a program.

The County provides hundreds of types of services. The Task Force developed a list of services based on categories of costs used in the Countywide Accounting and Purchasing system to assist in determining which services should continue to be billed. A decision matrix (see attached) was developed that provides a logical set of criteria to determine if each service should continue to be billed. Variables that need to be considered as part of the determination of whether to bill include the type of customer, the type of service, subvention requirements, and the materiality of the charges associated with the service.

The Task Force worked through some of the more material services and identified those that should be billed versus those that should be allocated using CCAP rather than billed, etc. Due to time constraints, the Task Force did not apply the decision matrix logic to all of the services provided. That task still needs to be prioritized and implemented on a phased-in basis.

Recommendation

- 6 The A-C along with departmental representatives lead a committee to jointly determine the types of services that should be billed or allocated using the CCAP in accordance with the criteria developed by this Task Force.

Takeover of Services

A takeover occurs when a department decides to provide for itself a service previously provided by another department. Historically, when one department took over a service from another department, the department receiving the service was required to take both the employees directly providing the service, and the indirect employees committed to supporting the transferred service. Recently, departments have been allowed to take over

a service without being required to assume responsibility for the provider's unavoidable indirect costs. The result of this new practice is that overall costs to the County may increase. In addition, if the indirect costs are not reduced or transferred the department losing the service must raise rates to remaining customers to compensate for the increase in per unit costs resulting from the spreading of indirect costs over remaining lines of business, or incur a budget deficit.

Takeover decisions have also been made with minimal consideration of some Countywide operational issues. For example, a department may desire to withdraw from the Telephone Utilities Budget to assume management of its phone service and the potential to achieve savings due to avoided indirect costs. However, billings from the Telephone Utilities Budget include an unavoidable indirect cost recovery component that finances services that benefit all County departments such as public referral and 24-hour emergency operators, telephone directory publication, regulatory analysis, and negotiated group service rates. A department's withdrawal from the Telephone Utilities Budget would result in unavoidable indirect costs being financed through higher rates to departments which continue to receive services from the Telephone Utilities Budget. In addition, the withdrawing department would continue to receive the benefit of many of the indirect services without the responsibility of paying for them. Also, the County would lose some of its leverage at negotiating service discounts due to the splintering of telephone services. Issues such as these as well as the loss of centralized coordination and technical expertise, and operational compatibility need to be considered from a Countywide perspective.

The Task Force concluded that takeover proposals should be independently evaluated by the A-C and CAO to ensure Countywide cost impacts, and operational and mission issues are given proper consideration. The Task Force does not believe that the current practice provides adequate analysis of the impact such decisions have on other County departments and the operations of the County as a whole. Rather, a department's decision to take over a service is currently based primarily upon the budgetary and operational impacts on their department.

The Task Force concluded that in determining cost effectiveness, takeover decisions should be made using guidelines similar to those used for Proposition A (avoidable cost) contracting analyses. Use of these guidelines will ensure that the Countywide cost effect (net gain or loss) of each takeover proposal is determined, not just the budgetary gain of the department taking over the service.

In addition, matters other than cost need to be independently evaluated from a Countywide perspective. For example, the potential loss of centralized coordination and technical expertise, the appropriateness of placing a service with a department whose main mission may not be operationally compatible with the service taken over, etc.

Finally, the Task Force concluded that for cases when a takeover is determined to be in the best interests of the County, there needs to be a transition process to allow the department previously providing the service to make an orderly reduction in previously billed unavoidable indirect costs. This reduction is often not possible, at least in the short term, because it is a fixed cost. Alternatively, the department will reallocate these costs to its remaining departmental clients if possible or incur a budget deficit. As previously noted, this negatively impacts the budgets of those remaining departments buying the provider's services by taking funding from other direct services even though they did not participate in the takeover decision.

Takeover proposals should consider providing a transition method that includes consideration of the following:

- ▶ The takeover does not result in an increase in the provider's rates for the service in the short term.
- ▶ If it is determined to be cost effective for a department to take over a service, the County should expand the analysis to evaluate whether it would also be beneficial for other clients to take over the service. Factors other than cost might also affect the decisions of these clients, and should be fully considered.
- ▶ The provider department might be able to make larger scale reductions in unavoidable indirect costs related to the takeover service if other departments also took over the service. For example, some semi-fixed indirect costs might become avoidable.

Recommendations

7. The A-C review cost related issues, and the CAO non-cost issues related to takeovers such as the potential loss of centralized coordination and technical expertise, the appropriateness of placing a service with a department whose main mission may not be operationally compatible with the service taken over, etc.
8. Avoidable costs analysis techniques be used to determine Countywide cost savings from takeover proposals.
9. A transition method be provided to allow provider departments to reduce unavoidable indirect costs in a manner that does not penalize other departments receiving the provider's services, and to provide the County a period to evaluate overall potential savings, if any, from additional decentralization of a service.

Funding Shortfalls, Cost Overruns and Substandard Performance

Current billing practices require that service providers obtain a CAPS Intergovernmental Purchase Order (IGPO) from departments requesting service to fund the service being provided. Adjustments to IGPO levels are made throughout the fiscal year to compensate for variances in the level of service requested and for unanticipated costs. If a department fails to provide IGPO funding or reimburse a provider for services rendered, the service provider may discontinue service and/or seek reimbursement through the arbitration process. In some instances, funding shortfalls may prevent departments from reimbursing service providers for services that are critical to a department's or the County's operations (e.g., Sheriff vehicle maintenance, health care facility utilities, etc.). Current billing practices put the burden on the service provider to stop rendering service, instead of requiring the buyer to be responsible for their obligation. Cessation of critical services when a department experiences a funding shortfall is often not an option, especially when the service provided is critical such as public safety and health care.

In the course of business, service providers occasionally exceed the agreed upon price for a service due to unanticipated costs. The increased costs are sometimes not authorized by the client department. In addition, client departments may perceive that a service they received was substandard and may incur additional cost to correct the problem. Absent a County policy on the assignment of responsibility for cost overruns and substandard work, departments resort to a negotiated resolution of responsibility for the costs, or existing arbitration procedures.

Current billing practice does not assign responsibility for additional costs incurred by service providers without prior authorization, or specify the circumstances under which a service provider is entitled to recover the additional costs from departments. In addition, current practice does not define responsibility for the cost of corrective action due to substandard performance, and responsibility for the costs of a critical service provided to a department experiencing a funding shortfall. The Task Force concluded that a policy is needed to standardize practices and define responsibility Countywide.

Recommendation

10. The CAO, in conjunction with the A-C, establish policy that specifies responsibility for cost overruns, unanticipated expenditures, the cost of substandard or warranty work, and responsibility for costs incurred to provide a critical service for a department experiencing a funding shortfall taking into consideration any OMB-A87 impact.

Billing Adjustments

Billing rates are generally based on estimates of costs and service levels because rates typically must be established during the budget process, far in advance of the dates when

services will be provided. Actual costs and service levels will vary from the estimates used at the time the billing rates were established due to changes in staffing, cost of materials, and service levels. As a result, departments that provide services will normally experience either over-recovery or under-recovery of their actual costs unless they process billing adjustments during the year. Billing adjustments can be in the form of rebates (i.e., billing credits) or increases in the amounts billed (i.e., mid-year rate increases.). The Task Force addressed the issue of whether billing adjustments were necessary, and if guidelines for processing billing adjustments were needed.

Currently, there are no formal guidelines governing billing adjustments despite their material impact on the financial condition of departments. Unanticipated increases in rates and the related costs can result in client departments exceeding their budget. Conversely, if billing credits (rebates) are not processed in a timely manner, client departments lose the opportunity to use available funds for mission critical activities.

Client departments generally have no problem receiving billing credits as long as they are notified of the credits in a timely manner. However, there is little tolerance for any billing adjustment that increases costs. Because of this, any department that provides services must inherently be very conservative in its estimate of costs (i.e., set rates higher), especially early in the fiscal year, to ensure rates recover the costs of the service. This situation encourages departments to wait until late in the fiscal year to process billing adjustments, particularly billing credits, because of potential variances in costs and service levels used to compute billing rates.

Because of the material impact billing adjustments have on departments' financial performance, the Task Force concluded there is a need to develop formal billing adjustment guidelines as follows:

- Require all departments that bill for services to reconcile billings versus costs periodically throughout the fiscal year.
- Require billing adjustments to be made in a timely manner throughout the fiscal year.

Recommendation

11. The CAO and A-C develop policies for billing adjustments based on the principles discussed above.

Billing Format

The E&E Commission report stated that many departments have full time personnel assigned to review bills they receive for accuracy. ISD's billing format has been designed and endorsed by a customer committee and is modified to meet customer requests. Billing disputes with ISD, as measured by arbitration, are virtually non-existent. However,

members of the Task Force expressed concern about the clarity and completeness of bills received from other County departments. Thus, the Task Force addressed the issue of a need for a Countywide standard billing format.

On August 30, 1990, the CAO and A-C issued an Interdepartmental Billing and Arbitration Policy. This policy stated that sufficient detail should be included in billings for departments to verify charges, but did not establish minimum standards for billing format or the components of bills.

To assist the Task Force in determining if Countywide standards for billing format and interdepartmental billing are needed, it solicited input from all members of the Administrative Deputy Network. The majority of responses indicated that billing formats should be worked out between the servicing and requesting departments. The Task Force agreed that a single specific billing format would not be practical due to the wide variety of services provided Countywide, variations in the information needs of each department, reporting requirements of third party funding sources, and departments' significant investments in existing billing systems.

The responses from the Administrative Deputy Network also indicated that some minimum standard for billing components should be established and departments should be required to use the existing CAPS Internal Voucher (IV) process as the method for interdepartmental billings. The IV process allows departments to approve billings in advance of posting to the accounting records.

The Task Force agrees that the lack of a minimum standard for billing components is resulting in many of the billing issues and/or complaints between departments. Thus, the Task Force concluded that the following minimum billing components should be part of all interdepartmental billings:

- Type of Service
- Units of Service
- Unit Cost
- Period of Service (month service provided)
- Current month and year-to-date charges
- Description of service

Departments should retain the ability to include as much additional detail as needed based on their needs and the needs of their clients. The Task Force did not agree as to a standard time frame for billing. However, the current policy of sixty days following the month of service is suggested as a reasonable maximum billing time frame.

Recommendations

The CAO and A-C revise the Interdepartmental Billing and Arbitration Policy to:

12. Include minimum standard billing components.
13. Require departments to use the CAPS Internal Voucher process for billing unless the servicer and requester agree to use some other process (i.e., Journal Vouchers, Direct Internal Vouchers, Work Authorizations, etc.).

Overhead and Indirect Costs

Overhead Rates

There has been concern raised regarding the reasonableness of overhead rates used in the billing process and the types of overhead costs allocated to County departments. The E&E Commission report included concern about the use of overhead rates as a basis for judging the efficiency of departments, and the perception by departments that ISD's overhead was too high.

Overhead rates typically include the indirect costs needed to support an organization's main mission function. They include, but are not limited to, costs associated with personnel management, accounting, budgeting, purchasing, building operations, and staff supervision. County departments identify indirect costs in order to calculate overhead rates

Overhead rates are typically calculated by dividing a department's indirect costs by the Salaries and Employee Benefit (S&EB) costs associated with staff providing direct services. For example, if a department had indirect costs of \$1 million and direct S&EB costs of \$10 million their overhead rate would be 10% (\$1 million divided by \$10 million).

Overhead rates are primarily used to comply with State and federal claiming requirements, and to allocate indirect costs to the various direct services offered by County departments. Overhead rates are needed to maximize the amount of allowable reimbursement the County receives for the administration of State and federally subvented programs.

Overhead rates are not an equitable means of judging a department's performance because of the variations of cost components that may or may not be included in the rates. The Task force recognized at least four common reasons for variances in overhead rates as follows:

Variances in S&EB Costs

There are wide variances in S&EB budgets among County departments and therefore there would be wide variances in overhead rates even if all departments had identical indirect costs. To illustrate, assume the following data for two fictional departments:

	Department 1	Department 2
Number of Direct Employees	100	100
Direct S&EB	1,000,000	1,500,000
Total Indirect Costs	300,000	300,000
Overhead Rate	30%	20%

If overhead rates were an indicator of efficiency, then the conclusion drawn from the example is that Department 2 is more efficient than Department 1 by virtue of its lower overhead rate. However, analysis of the components of the rate reveals that Department 2 only has a lower overhead rate because their employees are paid more than the employees of Department 1, thus providing Department 2 with a larger base from which to calculate their overhead rates.

Differences in Cost Accounting Practices

Overhead rates can also vary as a result of differences in the cost accounting practices used by various County departments. For example, one department may treat clerical costs as a direct expense because it directly supports a particular program. Another department may treat the same type clerical costs as indirect costs and, as a result, have less direct salaries and a higher overhead rate. The second department is not necessarily less efficient than the first department. They simply categorize costs in a different manner to meet their particular cost accounting requirements.

Differences in Operations

Departments will have different levels of indirect costs based on the inherent nature of their operations. For example, telephone costs are typically treated as indirect costs. A department that has a high level of contact with the public (e.g., DPSS, Assessor, etc.) will have proportionately more telephone related costs than those departments that have a lower level of contact with the public (e.g., CAO, ISD, etc.). In addition, departments necessarily have different levels of building related costs based on the

location of their operations. These examples demonstrate that department overhead rate variations reflect different operational requirements.

Differences in Assigned Costs

As part of the current budget process departments are assigned non-discretionary indirect costs over which they have little or no control. These costs include debt service on buildings they occupy that have been used as collateral for County debt, (see Funding Non-Discretionary Costs, page 16). Because the amount of debt service charged to departments bears little relationship to their operations, it proportionately inflates the overhead rates of departments assigned a greater burden of debt service.

Based on differences in the components and computations of overhead described above, the Task Force concluded that comparisons of overhead rates do not accurately assess the relative efficiency of a department's operations.

Contrary to overhead comparisons, components of overhead (indirect costs) are a better indicator of the efficiency or cost effectiveness of a program or service. For example, when comparing the human resources function (an overhead component) among departments, an appropriate measure may be the cost per employee. Measures of efficiency need to reflect the specific components that drive costs incurred. Non-cost based measures, such as supervisor-subordinate ratios, can also be used to measure workload and assess departmental efficiency. Comparisons should be based on components of indirect costs, or non-cost based measures rather than overhead rates, when evaluating the relative efficiency and/or cost effectiveness of a program or service.

Countywide Cost Accounting Issues

Funding Non-Discretionary Costs

There are several categories of costs (e.g., debt service, general liability costs, etc.) that are charged against departments' appropriations as part of the CAO's efforts to decentralize costs. In addition, the Department of Human Resources (DHR) was created and funded by charging each department for a portion of DHR costs. The primary reason for allocating these costs was to increase departmental accountability for all of the relevant costs of their operations and provide an incentive for departments to achieve savings.

For some departments, costs have been allocated to them without consideration of the level of service received or the department's main mission, and the costs are not subject to departmental management control, including cost cutting efforts. For example, some departments are allocated a portion of the Countywide cost of debt service. The cost of debt service is fixed and is not subject to management control. If debt service costs were discretionary, department management could take proactive steps to reduce or eliminate the costs. The Task Force concluded that non-discretionary costs should be centrally funded and not allocated to departments unless there is an overriding public policy need.

Recommendation

14. The CAO consider centrally funding non-discretionary costs, and not allocating these costs to departments unless there is an overriding public policy need.

Responsibility Accounting

The E&E Commission report indicated a need for responsibility-based accounting. Under such a philosophy, according to the Commission, "Departments would be charged for costs and credited for revenue based on their responsibility for the incurrence of the costs and revenue. A responsibility-based accounting system is an essential first step in the ability to hold departments accountable for their performance."

The Task Force agrees with the need to hold departments accountable for their performance. Current County accounting methods do allow for responsibility based accounting. Departmental revenues and expenditures are accumulated in the Countywide Accounting and Purchasing System (CAPS) by cost center, and by description within each cost center. Properly utilized, the results of operations for a particular line of business can be determined based on this system, and management held accountable for the fiscal results of services they control.

A responsibility-based accounting system is dependent on department management's insistence that revenues and expenditures be recorded at a low enough level within the cost accounting hierarchy to make them meaningful for the service being managed. Department managers need to ensure they accumulate costs and revenues for each service or program within individual cost centers to ensure that responsibility for the costs and revenues is clearly delineated.

While individual accounting systems vary from department to department, most departments maintain some sort of hierarchical cost accounting system. Based on current practice the Task Force concluded that the County does have the ability to hold department management accountable for their financial performance as long as revenues and expenditures are recorded at the lowest practical level within the department's cost accounting system or CAPS.

Recommendation

15. Department management be encouraged to record revenues and expenditures at the lowest practical level within the department's cost accounting system or CAPS.

Monopolies

The E&E Commission questioned the availability of incentives to make a service provider more efficient, the level of control a department has over cost incurrence, and if charges for services should be market based. They further questioned the ability to make a provider more efficient if that provider holds a monopoly on the service.

The Task Force concluded that the primary incentive for a service provider to reduce costs and improve efficiency is when customers have a choice of providers. For discretionary services, departments receiving services are in a better position to make decisions on service levels rather than providers. The needs of the department combined with the incremental cost of consuming more services will result in department management making service selection decisions that promote the efficiency of their operations. However, without a choice of providers, department management has little control over the price charged by a monopolistic provider.

For some services a monopoly is necessary to provide centralized control or coordination of services. Examples of necessary monopolies include the A-C, CAO, and County Counsel.

The relative efficiency of a monopolistic provider can be assessed through the management audit process. The assessment would include qualitative as well as quantitative assessment criteria, bench marking and performance comparisons, and incorporate the satisfaction with the service or program as perceived from both within the organization delivering the services, and from the customer or client point of view.

Recommendation

16. The County utilize the A-C management audit process to assess the quality, economy, efficiency, effectiveness, and customer satisfaction of monopolistic providers.

Billing and Cost Recovery Task Force Central Support Services Decision Matrix

Attachment

